Guernsey Hedge Fund Services 2007

Harwood Report puts seal on new regulatory regime
Exchange-listed funds raise island’s international profile
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At international gatherings and seminars, representatives of Guernsey’s financial industry, not least its fund sector, continually reinforce the theme that the island is “open for business”. It’s necessary, say practitioners, to counter suggestions from the jurisdiction’s rivals in the offshore world that the Guernsey industry somehow lacks the capacity and capability to accept a greater share of international financial services business.

Actions speak louder than words, however, and over the past year or so Guernsey has left potential clients in no doubt that it is both able and willing to compete strongly for business. First came the much-anticipated release of a report by a working party headed by leading advocate Peter Harwood, drawn up following extensive discussions with the Guernsey Financial Services Commission and industry members, that sets out a new blueprint for regulation of the island’s fund sector.

The Harwood Report, as it is universally known, builds on the commission’s established principles-based approach to financial supervision and extends the focus on regulation of service providers rather than products introduced with the Qualified Investor Fund regime in February 2005. The first fruit of the report, whose recommendations are expected to be fully implemented later this year or in the first quarter of 2008, is the regulatory framework for closed-ended Registered Funds, launched at the beginning of February.

The new regime, under which a fund’s administrator undertakes due diligence checks such as ascertaining the promoter’s integrity and competence on the commission’s behalf, in return for an accelerated approval process, dovetails neatly with the growing attractiveness of Guernsey closed-ended funds among managers of hedge funds and private equity seeking to establish ‘permanent capital’ vehicles, usually listed in London or Amsterdam.

The island is already well established as a domicile for funds of hedge funds that have been listed on the Main Market or Alternative Investment Market of the London Stock Exchange, but what seized the attention of alternative fund managers worldwide was the listing on the Euronext Amsterdam exchange of the EUR5bn KKR Private Equity Investors vehicle by Kohlberg Kravis Roberts, doyen of the US private equity industry.
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The value of Guernsey closed-ended funds under administration increased by GBP17.4bn or 55.8 per cent in 2006 to a new high of GBP48.5bn, helped in part by the trend among investment managers to raise permanent capital on the London Stock Exchange, London’s AIM market or Euronext Amsterdam.

Guernsey has become the jurisdiction of choice for fund promoters and sponsors considering listings for a broad spectrum of hedge funds, funds of hedge funds, private equity, syndicated loans and property vehicles. According to ABN Amro research, at the end of last year 37 listed funds of hedge funds and three single-manager hedge funds had a combined market capitalisation of GBP5.9bn, an increase of GBP2.4bn or 70 per cent in 2006.

Public listing enables managers and promoters of funds of hedge funds to take a longer-term investment perspective, and offers greater transparency for shareholders, competitors and market-makers to the underlying portfolio. Investors in closed-ended listed funds also benefit from broader corporate governance requirements, such as the UK Listing Authority’s combined code on corporate governance for companies listing on London’s Main Market.

Under Guernsey’s new Registered Funds regime, closed-ended funds need no longer undergo the established weeks-long consent application process. Instead, consent may be obtained within three days of the administrator certifying to the regulator that the promoter is fit and proper and of satisfactory integrity, solvency and competence.

Historically, when UK and Guernsey legal teams and the lead sponsor guided the promoter through the launch of a fund, the appointment of an administrator was generally one of the last aspects to be decided. This sometimes led to a perception that fund launches were delayed by the administrator’s timeframes for conducting due diligence on the promoter and documenting and transitioning the fund.

The new regime, which effectively puts promoter and administrator in partnership from the outset, is welcomed by Royal Bank of Canada. Its team-based approach to prospective fund launches places RBC’s business professionals in banking credit, corporate trustee, fund accounting/administration/valuations and global custody and their support teams in front of promoters from the first meeting.

Regular meetings with the client clear up issues such as the roles and responsibilities of the corporate secretary, including the weekly estimate preparation and timeline and agreement of templates for RNS reporting, the treatment of currency hedging valuation and cost across share classes, processing of share conversion programmes and trailer payments, and changes in financial reporting.

Royal Bank of Canada (Channel Islands) acts as custodian to some USD22bn in hedge fund assets and provides ancillary services such as currency hedging and timing and settlement financing to funds. Passive hedging is critical to the performance of fund share class prices and, where a fund is closed-ended, the availability of a credit facility helps the promoter to purchase investments against future redemptions or invoke the discount provisions clause.

RBC’s Corporate & Institutional Business operation provides fund administration and global custody services to alternative and traditional investment vehicles at offices in the Caribbean, Guernsey, Jersey, London and Edinburgh. RBC entities in Guernsey act as custodian and fund administrator to the largest London-listed fund of hedge funds to date and as custodian to Alternative Investment Strategies, which became the exchange’s first closed-ended fund of hedge funds in 1996.
Not all the high hopes engendered by the KKR float have been fulfilled, partly because the issue soaked up so much capital, but also on account of the price discount to net asset value that persisted in the fund’s first months of trading. However, as the appeal of permanent capital has grown over the past 12 months, along with increased investor appetite for the liquidity that comes with listing on a major exchange, Guernsey has stolen an important march on rival domiciles.

In the meantime, efforts over the coming months to implement the remaining Harwood Report recommendations are set to keep the island in the spotlight and, practitioners hope, further boost the perception abroad that the authorities are attentive to the needs of both fund sponsors and investors. However, opinions differ as to how far the changes usher in a genuinely new style and substance of regulation and how far they reshape existing practices in a unified and more coherent legal framework.

“It will deliver a streamlined regulatory process,” says Graham Hall, managing partner of the corporate group at law firm Carey Olsen. “Some of our legislation, although very good, is in need of updating, such as the Protection of Investors legislation. It has been changed to adapt to new circumstances, but it’s now time for a thorough review and to have some uniformity between our various structures.

“For instance, closed-ended structures in Guernsey are regulated principally under the Control of Borrowing legislation, which dates back to the days of exchange controls. These were abolished many years ago but we’ve kept the controlling ordinance as a means of regulating the raising of capital through equity or loans. It’s primarily used for regulating the closed-ended fund sector, and it’s time for that to be brought into line with the Protection of Investors legislation.”

The author of the report says it serves an additional purpose. Harwood, a partner with Ozannes, says the importance of the fund industry will grow following the implementation of tax reforms that will reduce the rate of corporate taxation for most Guernsey companies to zero, while certain financial institutions such as banks will pay a rate of just 10 per cent on their profits. This will swing a greater proportion of the tax burden onto individuals, he says.

Creating a standard corporate tax rate of zero has become the standard response of the UK’s crown dependencies and other offshore jurisdictions to a demand by the European Union that they harmonise the tax treatment of domestic and offshore companies. However, it will leave a gap in tax revenues that must be filled. Says Harwood: “With the 0/10 tax regime, the focus of tax gathering will clearly be on individuals rather than corporate vehicles.

“We therefore need to create more highly-paid jobs, and the [fund] industry will probably be predominant in that process. The States of Guernsey have been asked to loosen up their policy on the availability of housing licences and the ability to bring in people from outside the island, because we need to attract high value-added business. While it is possible to outsource a lot of the more mundane back office work, Guernsey needs an environment that will attract front-office people, who are actually taking investment decisions or are key to marketing, who are paid reasonable salaries and therefore will increase the tax take.”

Harwood believes that the new approach will banish any lingering perception of an onerous regulatory environment that might have deterred business in the past. “Guernsey has always been regarded as well regulated, but there was frustration at what was perceived to be a slightly laborious regulatory process, which was in fact perhaps more perception than reality,” he says.

“But when you explain to people about the three-stage [fund authorisation] process and you can never offer guarantees, there is
always some uncertainty about timetables. The registered fund regime removes that uncertainty. It means we can compete more easily with jurisdictions like Cayman where the regulatory process has never been a stumbling block, or Jersey, which has already benefited from the introduction of Expert Funds.

Peter Moffatt, director of investment business at the Guernsey Financial Services Commission, says the new regulatory philosophy reflects the maturing of the island’s funds industry. “Traditionally our approach has been that for anyone wanting to domicile a fund in Guernsey, the fund itself and the offering documents have to be vetted by the commission, to ensure the sponsors are fit and proper, and have the experience to know what they are doing,” he says.

“As the industry has matured, we felt our vetting of the offering documents in particular didn’t necessarily add as much value as it did at the outset. Investors in institutional vehicles such as insurers and pension funds have access to all the expertise and skills to work out whether the fund is suitable for their needs and has the right risk profile. We shouldn’t really be trying to second-guess that.

“This is even more true where the fund will to be listed, because the prospectus will also go through the listing process, which is designed to ensure the right disclosures are made, and it didn’t seem obvious that the commission was adding much value. On the other hand, institutional investors expect the same rigorous standards of administration as retail investors once the fund is up and running. The whole idea of registered funds is that not really vetting the prospectus allows us to shift our monitoring effort onto the ongoing administration and custody of the vehicle.”

According to Peter Franks, a partner with Ernst & Young, the regulatory changes in Guernsey over the past two years have already broadened considerably the range of business the island is attracting. He says: “We’ve seen a wider range of alternative funds set up in Guernsey, such as renewable energy funds buying wind farms throughout the world, or timber funds buying tracts of timber across the globe – structures that are probably more commonplace in the US environment but not so much in Europe. We used to be reliant on business from the UK, but we now have German, US and Asian managers. We are becoming a more global player.”

Hall says the streamlining of the approval process and the shifting of responsibility for due diligence onto the administrator is already proving popular with clients. “Demand increased significantly in the first weeks and months after the introduction of the regime,” he says. “That surprised me because a lot of thought goes into the creation of an investment fund – it isn’t something you do in three days, and if you have a listing with Euronext or in the UK you’d have a review anyway from the respective listing authorities. But what is helpful to the client above all is certainty.”

According to Ozannes partner Gavin Farrell, the detail of Guernsey’s regulatory regime is less important than the spirit of cooperation between the commission and the industry that underpins it. “People come to Guernsey because they want a certain level of regulatory protection but they don’t want it to be over-burdensome,” he says “There’s a great deal of flexibility and commercial acumen at the commission.

“There’s a dialogue between us that means that on a case by case basis we can discuss how to move forward with a particular transaction or product. For managers, it’s another stamp of approval for something that’s always been established in practice. The registered closed-ended fund regime offers a mixture of the Guernsey, UK and Cayman regimes, because you still have the Guernsey regulatory consent, the Cayman system of registration, and the UK emphasis on the service provider rather than the product itself. The next step will be to amend the law to extend the registered fund process to open-ended schemes.”

Harwood notes that all Guernsey funds come under some sort of regulatory scrutiny, something that does not apply to a number of...
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At first sight, Guernsey might not appear the obvious choice as a hedge fund jurisdiction, far from the traditional domiciles used by the industry in and around the Caribbean and long accustomed to having to maintain its competitive edge with its larger Channel Island neighbour Jersey.

Yet the island has turned what might have been viewed as drawbacks into advantages. Never initially enjoying the same success as Jersey in attracting traditional retail funds, Guernsey opened its doors to the alternative sector long before it was fashionable. Over the years the jurisdiction has built up an impressive level of expertise not only in hedge funds but funds of hedge funds, property funds and private equity and other, more complex, alternative fund structures and strategies. On the opposite side of the Atlantic from the most popular hedge fund domiciles, Guernsey has set out its stall to managers looking to attract European investors who find it useful to demonstrate a higher level of regulation.

Certainly, Guernsey’s hedge fund administration sector is modest in size compared with that of Dublin, but then the aim of the island’s leaders has long been to focus on higher value-added work that calls for intellectual capital, as opposed to large numbers of employees, and the industry has never chased low-margin activities that will inevitably find their way to the jurisdiction that can provide them most cheaply.

Instead, Guernsey has looked to gain an advantage by re-examining the way financial services activities, including alternative funds, are regulated. Last year a working party chaired by Ozannes partner Peter Harwood set out the blueprint for a new, coherent, framework for the island’s supervisory regimes and a new approach to the fund sector, focusing on fund administrators rather than the products they service.

The first fruit of the Harwood report, the Registered Funds regime introduced earlier this year for closed-ended products, is the latest in a long line of innovations that have helped to keep Guernsey in the forefront of international fund jurisdictions. A decade ago it became the first offshore financial centre to introduce protected cell companies, a structure once scorned by rival jurisdictions but now so successful that it has been copied all over the world and spawned variations such as the incorporated cell company.

The PCC has proved particularly useful to the hedge fund industry by providing the legal basis for an incubation platform which allows fledgling managers to develop their strategy and establish a track record while benefiting from common facilities covering areas such as administration, IT systems and sometimes capital introduction.

Meanwhile, Guernsey has maintained a strong position as a centre of expertise for funds of hedge funds with experience going back more than a decade. The island has had an important asset in the flexible and straightforward approach of the Guernsey Financial Services Commission, winning business from rival jurisdictions where authorisation processes have been perceived, certainly in the past, to be cumbersome and difficult. It has also benefited from remaining outside the European Union and the requirements of legislation such as the Prospectus Directive.

Today jurisdictions around the world are amending their legislation and reviewing their regulatory processes in an effort to win a share of the burgeoning alternative fund industry. But while laws may be rewritten, a true sense of partnership between industry and regulator, expressed in a regime that combines commercial acumen with appropriate standards of oversight, is harder to replicate.
other jurisdictions. “There’s a lot of fund work in Jersey that never comes on the regulatory radar screen,” he says. “All Guernsey investment funds get caught, whereas other jurisdictions have certain carve-outs that help different sectors, notably private equity.”

However, Guernsey has no ambition to emulate the Cayman Islands, the predominant domicile for the global hedge fund industry with more than 8,000 active funds as well as an unknown number of additional alternative investment vehicles such as private equity partnerships. Harwood says there is no interest in recreating a model that relies on a combination of market forces and regulatory oversight in other jurisdictions where funds are administered, listed or managed.

“A number of people made representations to the working party that we should follow the Cayman model,” he says. “Very few Cayman funds are administered there – at least 90 per cent are administered in other centres, primarily Dublin. There are a lot of hedge funds floating around without really having a regulatory base, just the Cayman audit sign-off. But we insisted we had to have a clearly identified regulatory base in Guernsey, with administration carried out by a licensed entity that is answerable to and responsible to the commission.”

A significant area of growth for Guernsey administrators consists of servicing of funds domiciled in other jurisdictions, including Cayman, particularly following the removal of a requirement that subjected such funds to a second level of regulation by the island’s regulator. Does domicile matter? “It’s really a commodity,” says Richard Boléat, a director of Capita Fiduciary Group who is based in Jersey. “It’s very rare in my experience for investors to draw conclusions about a fund from whether it is domiciled in Jersey or Guernsey, and why would you?”

However, it may be important particularly for London-based investment managers seeking to ensure that their offshore funds do not fall into the UK tax net. “Guernsey domicile has some value in demonstrating tax nexus,” he says. “If a fund is domiciled in one jurisdiction and the board of directors sits in another, there are technical arguments about where that fund is truly tax-resident.”

Adds Peter Niven, chief executive of GuernseyFinance, the island’s promotional agency for the industry: “Increasingly people are finding that HM Revenue & Customs are being very much more robust in looking at offshore structures, and in some cases are not looking any further than the London manager. If the fund is registered in Cayman, the administration is done in Dublin and the board sits anywhere, they may decide it’s all effectively run out of the UK. But with a Guernsey structure, you look straight through the manager into Guernsey – that’s where the hearts and minds are, where the decisions are made.”

GuernseyFinance is spearheading a long-term campaign to attract investment managers to move all or part of their operations to the island, not only to improve the tax position of the firm or its principals – although the switch to the 0/10 corporate tax structure clearly helps - but to take advantage of the quality of life on an island that is barely an hour’s flight from London.

“We’re working hand in hand with our colleagues in Commerce & Employment to attract high net worth individuals to the island, including hedge fund managers,” Niven says. Echoing Harwood, he adds: “With the shift from corporate toward individual taxation, the more high earners we can attract to the island, the better for us.”

Guernsey already has a small but significant fund management industry, including managers of both alternative funds and traditional assets as well as some, like Collins Stewart, that straddle the two categories. Says chief investment officer Kevin Boscher: “There are a few more boutique-type managers like ourselves, and some more hedge funds that have established on the island. But there aren’t many that are now as big as Collins Stewart, drawing on resources in Jersey, the Isle of Man and London as well as Guernsey and managing a total of GBP2.7bn.”
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The boost to Guernsey’s image as a centre for hedge fund services resulting from the recent legislative and regulatory changes can be readily gauged by the growing list of funds that have been established on the island, in particular permanent capital vehicles from large hedge fund managers and private equity firms. Over the past year or so Guernsey has become the jurisdiction of choice for this form of capital-raising. While the launch of high-profile Guernsey-domiciled private equity and hedge fund vehicles on Euronext Amsterdam and the London Stock Exchange has certainly raised the island’s international profile, especially among US managers, it may not result in the flow of repeat business seen in other areas of the alternative fund industry.

Once a permanent capital vehicle has been established, the manager is unlikely to launch more such vehicles for a while, although further capital-raising exercises are possible. In addition, the recent surge of business coming to Guernsey has been assisted by extremely favourable market conditions that are unlikely to persist indefinitely. By contrast, many of the issuers of traditional closed-ended and some open-ended vehicles have launched a series of funds onto the market to exploit different strategies, bringing plenty of repeat business to service providers.

The work that is now coming into Guernsey is extremely varied. For example, over the past year Capita has received a number of instructions relating to funds investing in Eastern European opportunities, which are widely viewed – Russia apart – as a European Union convergence play. Various managers have established infrastructure and deal-making capabilities on the ground and are selling market beta exposure into the wider hedge community while taking their own bets on real estate, private equity and other non-traded market exposure.

Another significant area of interest for new funds is investment in structured debt. Capita has worked on several transactions involving the establishment of collateralised debt obligation funds and more are in the pipeline. Managers are looking at risk arbitrage in the CDO market after the sub-prime mortgage meltdown in the US, so more products of this type are likely to come to both Guernsey and Jersey in the future, principally from US managers who see opportunities to raise capital from UK and European investors.

For administrators, the primary additional issue involved in the servicing of listed funds is compliance with the listing rules of the exchange. Managers who seek to list their funds on a market with which they are not familiar are dependent upon the administrator to ensure the fund is in compliance with the rules, especially the exchange’s regulatory filing requirements.

In markets such as Euronext there are additional complications such as the use of civil law rather than common law and an environment where English may not be the primary language. These issues present a range of administration challenges, but Guernsey stands out with its wealth of experienced people with wide-ranging skills and knowledge of the fund sector and of financial markets generally. Few competing jurisdictions possess the same strength in depth.

Guernsey is now viewed by investors as a mainstream jurisdiction for alternative funds. Both sponsors and investors take comfort that it has been operating for a long time, there is expertise across all the relevant disciplines, and its governance standards are well established – an increasingly important factor for an industry model moving to a greater degree of independence between fund managers and sponsors.
The alternative fund services industry in Guernsey continues to confound predictions that worldwide the sector is moving toward consolidation around a handful of giant players. While the island has seen its share of mergers such as HSBC’s acquisition of Bank of Bermuda and Northern Trust’s purchase of the Barings fund administration business, the number of administrators in Guernsey is growing larger rather than smaller.

The conventional wisdom is that as the administration of hedge funds and other alternative vehicles becomes more process-driven, an inexorable advantage will accrue to those organisations that have the resources to make massive investment in the automation of systems. This trend will be exacerbated, according to this view, by the relative shortage and therefore higher cost of human resources in island centres such as Guernsey, which will make the use of information technology to build scale even more attractive.

In addition, new regulatory developments that shift the burden of due diligence for the fast-track approval of certain types of alternative funds from the island’s regulator, the Guernsey Financial Services Commission, to administrators should by this analysis favour providers with greater resources to devote to this process. Finally, the increasing complexity of many alternative funds might also be thought to favour bigger players.

While these trends should not be ignored, much of the evidence so far suggests that the expected consolidation is for a later date, if at all, as far as the Guernsey market is concerned. Instead of forcing small players out of the game, they are increasingly occupying niche areas of the market, where a hands-on, personalised style may be more important to the client than number-crunching capabilities.

In fact, the increasing reluctance of large administrators to take on small or start-up clients is leaving a wealth of business...
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Fund administration companies, like the funds they manage, come in all shapes and sizes. The spectrum ranges from boutiques in one particular jurisdiction and mid-size independent firms to global custodians and the administration arms of private banks, as well as specialist departments of trust companies and law firms. All have a part to play in the dynamic world of offshore fund administration and in the burgeoning Guernsey fund services industry.

Whatever the size and structure of the administration firm, its ability to survive and thrive is dependent upon a willingness and ability to undertake continuing strategic investment in people and technology, backed by a long-term corporate commitment to the fund administration business. This is especially true for administrators that service the alternative fund sector.

The global fund industry itself accommodates an enormous diversity of structures, strategies and investor profiles, from retail funds with thousands of unitholders to private equity and venture capital vehicles that raise funds as required through capital calls, and hedge funds and funds of hedge funds with multi-class series accounting. For the most basic structures, net asset values can be calculated on spreadsheets and unitholder recordkeeping carried out through off-the-shelf database software, applications that have long been the staple technology for valuations and general company administration among smaller administrators. Other companies have used legacy custody systems for administration functions, bolting on software applications as needed.

But other administrators have opted to make significant technology investments year after year to meet the much more demanding requirements of many hedge funds and funds of hedge funds today. Administrators may be called on to handle investment manager and prime broker trade fees, multi-currency and multi-share class master-feeder structures, and series accounting or equalisation shares to calculate performance fees, and to service corporate or partnership structures across multiple GAAP standards, along with the associated tax reporting.

But investment in people is no less important than technology. Today’s increasingly complex fund structures and sophisticated strategies call for the deployment of a highly-skilled administration team capable of understanding the fund’s operation and working as a strategic partner with its sponsor. This issue is complicated in the offshore centres that dominate the alternative administration sector by tight labour markets that require great efforts on the part of administrators to attract, retain and develop the skills of their staff.

The importance of technology and people and the size of the ongoing investment required require a long-term corporate commitment. Administrators unwilling or unable to make this commitment are likely to see their market position eroded if service quality suffers as a result and fund sponsors look for greater assurance about the stability of their service provider relationships.

In Guernsey, a process of consolidation is creating bigger and more focused players in the areas of fund administration, fiduciary and legal services and global custody. Combined with a flexible regulatory regime, the island is well placed to attract a greater share of the growing alternative fund services industry.

While being part of a global financial services business brings obvious advantages in availability of resources and the operational benefits of a global network, ultimately the size of an administration firm is less important than the long-term commitment of the organisation to the business and to the people whose skills deliver the level of service that clients require.
opportunities for smaller providers in a wide range of alternative fund services jurisdictions, including Guernsey, and is prompting the establishment of new market entrants to take advantage. And the commission says that if some administrators have taken time adjusting to their new responsibilities, it is not necessarily the smaller ones.

There’s no doubt that the Guernsey fund services industry is currently in blooming good health. Fund assets under management or administration in the island grew by 7.8 per cent in the first quarter, the latest for which the regulator have published statistics, and by 26 per cent over the 12 months to the end of March, for a total of GBP140.4bn. Industry members expect this level of growth to continue under the impact of new regulatory initiative such as the launch in February of registered closed-ended funds.

According to the financial industry promotional organisation Guernsey Finance, 32 registered funds had been authorised by mid-June. The commission had also approved more than 100 Qualifying Investor Funds, which first introduced the shift in due diligence responsibility to the service provider in exchange for an acceleration consent timetable, between the launch of the regime in February 2005 and the end of March this year. The volume of funds domiciled outside Guernsey but administered in the island has also been growing, albeit at a slower pace, to GBP25.3bn at the end of the first quarter.

“We’ve seen extraordinary growth this year, with figures for funds under administration up nearly 30 per cent,” says Roger Le Tissier, a partner with leading offshore law firm Ogier. “But what is interesting is that over the past year I’ve done two venture funds with more than EUR5bn that so far haven’t drawn any funds down. The commission’s figures only reflect funds that are actually drawn down, but figures for committed capital would be massive. The money that will be coming into the island over the next two to three years runs into many billions.”

Aside from the figures, the industry received an important endorsement in June with the announcement that Citco Fund Services, the world’s largest hedge fund administrator with more than USD500bn in assets, had received a licence from the commission, citing Guernsey’s role as an "internationally recognised but pragmatic regulatory environment which we believe will continue to make it a jurisdiction of choice for many hedge funds and funds of funds operators”.

Some of the larger administrators insist that scale remains important. “The large global players are committed to investing in infrastructure, technology and straight-through processing to make it seamless to the client,” says Brenda Petsche, managing director of HSBC Securities Services (Guernsey). “The smaller niche players offer a bit more hand-holding and expert advice in a particular area. However, boutiques are more reliant on their auditors and legal firms to provide additional support, whereas larger players like ourselves can provide that in-house. It’s all wrapped up in our overall fee proposition.”

Petsche is echoed by Kate Stallard, who is responsible for business development for the Channel Islands at Northern Trust. “The larger providers, such as Northern Trust, can offer fund administration services coupled with the advantages of an integrated custody and banking solution, including liquidity, foreign exchange hedging facilities for funds of hedge funds and access to a global
technology platform for reporting purposes together with performance measurement and analytics," she says. “In addition, they also offer more extensive in-house corporate secretarial, compliance and legal teams which assist in addressing new regulatory requirements and business growth.”

However, most of the new firms entering the administration market are at the other end of the scale from Citco. “New administrators are emerging from banks and trust companies that see the potential in this market,” says Neale Jehan, who leads KPMG’s services to the alternative investment sector in the Channel Islands. “A few of those are growing very quickly to become middle-tier firms and even challenging some of the big players for business.

“People often ask me if Guernsey has a capacity issue with administration, but these new firms are really hungry and building with both people and systems, taking up a lot of the new work.” While some of the newcomers are specialising in areas such as private equity or property funds, he says: “Firms may start out in a sector they are comfortable with, but a few are looking more widely at the alternatives sector as a whole.”

The emergence of these new players is epitomised by Heritage International Fund Managers, which has existed since 2001 as the administration business of Guernsey’s leading captive insurance manager but has developed rapidly since the Heritage group completed a management buyout from UK insurer Hiscox two years ago and especially following the recruitment of Mark Huntley and several senior members of his team from Northern Trust.

Huntley, who has overseen growth in assets under administration from a nominal amount to more than GBP4bn since his arrival as managing director in early 2006, says that in many ways the Heritage operation represents a return to the philosophy at Guernsey International Fund Managers, as the Barings unit was known before its acquisition by Northern Trust. “We’re doing the stuff where we made our reputation, such as private equity, property and funds of hedge funds,” he says.

“We have been able to put together a full-service capability with the benefit of the Heritage infrastructure, giving us a strategic advantage over competitors who are starting from scratch. We’ve been able to attract larger clients like Lehman Brothers, Colony Capital and Babcock & Brown, as well as assist new specialised managers that find our model of an experienced team within an independent organisation very attractive. We don’t have any conflicts of interest because we’re not a bank, we don’t have a custodian business and we’re not a law firm.”

Heritage wins high praise across the industry for the professionalism of its staff and the solidity of its infrastructure, but some members have reservations about the influx of new players. Some of them may not have the ambition or the means to make the investment required, warns senior manager Steve Fell of Fortis Bank (Channel Islands), which offers custody services but not administration in Guernsey.

“There has been an explosion of new launches, primarily on the fiduciary side, where they have seen the opportunity to bolt a fund administration activity onto their traditional fiduciary, trust and company administration business,” he says. “It’s a very specialised area, and you can’t just cobble together a system. To do it properly, you need to put proper investment into the systems required for a 21st century fund administration operation.

“Heritage has done the job properly – they’ve identified a niche and employed people with the right level of experience and
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Few practitioners in the Guernsey fund industry would dispute that the establishment of a closed-ended private equity vehicle by venerable US buyout firm Kohlberg Kravis Roberts and its listing on the Euronext Amsterdam exchange last year was a pivotal moment for the island’s alternative funds industry.

At a stroke, Guernsey became the jurisdiction of choice for the domicile of vehicles launched by private equity and hedge fund managers to attract permanent capital, offering sponsors a respite from the near-constant round of fund-raising as their existing vehicles reach capacity and providing investors with the option, rare for a hedge fund and even more so for private equity, of daily liquidity on a stock market.

This new prominence for the island, which has a long-established but previously low-key expertise in the domicile and servicing of closed-ended fund vehicles, has come at a time when interest in permanent capital vehicles has never been greater, with managers on both sides of the Atlantic looking to the capital-raising potential of the public markets. This has prompted initiatives such as the London Stock Exchange’s plans to create a specialist market for alternative investment funds.

Guernsey has always enjoyed a flow of business from the US to varying degrees, but the pace has picked up significantly following the launch of KKR Private Equity Investors, which raised USD5bn when it was launched in April 2006. This was a landmark deal in the private equity sector because it was the first fund to be listed on Euronext following the conclusion of a memorandum of understanding between Guernsey and the Netherlands. The agreement made Guernsey one of only four jurisdictions in the world where the Dutch regulator, the AFM, has ruled that home supervision is sufficient to dispense with the requirement for investment funds to obtain a licence in the Netherlands if they wish to list on the Amsterdam exchange.

Having spent a total of 18 months preparing the KKR deal, a large part of that in determining and meeting the requirements of Euronext and the Dutch regulator for the vehicle that was to be established, Carey Olsen encouraged the Guernsey Financial Services Commission to reach agreement with the AFM. KKR wanted not only European exposure but to create liquidity in the market, an ambitious task because a listed private equity vehicle on such a large scale was unknown. The firm chose Guernsey because of its reputation and location, and because the commission’s relationship with the Dutch regulator held out the possibility of an agreement that would avoid the need for supervision in the Netherlands.

Having acted for the issuer, within two weeks of the deal being completed Carey Olsen had received around 15 enquiries from KKR’s competitors, who were all interested in creating a similar vehicle. In the end most of these plans failed to come to fruition, in part because the KKR issue was so large that investor demand for this kind of product was temporarily sated.

However, over the past year a number of similar deals have been completed for alternative funds including CMA Global Hedge, a Guernsey protected cell company that attracted USD402m for a fund of hedge funds listed on the London Stock Exchange, and MW Tops, which raised EUR1.5bn on Euronext for two underlying hedge funds run by London manager Marshall Wace.
expertise, and have committed to making the necessary systems investments. But a number of players that have seen the opportunity have not carried out the intensive investment required if Guernsey is to maintain its reputation. The commission is aware of the dangers. As an offshore jurisdiction we have to be whiter than white. It only takes one bad apple, and all that work is undone."

To date, however, the regulator is satisfied with the practical impact of the new regimes that place greater responsibility on administrators. "Six months after the QIF regime came in, we did a quick survey of the market to make sure the warranties we were getting were properly supported by the firms’ internal processes and implementation," says the commission’s director of investment business Peter Moffatt.

"A number of firms that we inspected did it excellently. One of two, especially in the case of longstanding clients, had all the information but hadn’t drawn it together in a way we could access immediately. We persuaded them that if they were going to make these warranties, it was important for them to make very sure they stood up." A similar monitoring exercise is scheduled for around six months into the registered funds regime.

"If people don’t meet the standards, our first sanction is that we won’t accept registered funds or QIFs from them; it is the licensed administrator who makes the application, so if they can’t make those warranties stand up through their internal processes, in the worst case they’ll be out of that part of the business. But we haven’t felt the need to do that so far."

The commission does not see particular problems among smaller administrators in fulfilling their responsibilities to the regulator under the QIF and registered funds regimes. Says Moffatt: "We’ve not necessarily found problems at the smaller end of the market - in fact small firms seem to find it easier, perhaps because they are more focused. Certainly I don’t think the implication is that administrators have to get bigger or that the warranty process gives an advantage to bigger firms."

He notes that most issues that arise with administrators can be dealt with through dialogue, but the commission is looking to broaden its range of disciplinary powers. "At present we have the power to remove a licence, the nuclear option. Alternatively we can impose conditions on a licence, typically where a firm’s internal control environment is not strong enough, but we are seeking wider powers to impose automatic penalties if various reports don’t come in on time. It stops people being lazy."

An important area in which the commission has clarified the rules for administrators is outsourcing. Carrying out lower-value added functions in other jurisdictions is seen as a key way of enabling the sector to grow without placing an unacceptable strain on limited resources in Guernsey or burdening firms with a level of costs that would diminish their competitiveness.

According to Peter Harwood, a partner with Ozannes and head of the working party that produced the report that bears his name, the regulator’s willingness to countenance outsourcing is now more clearly articulated that in the past. He says: "There was always concern that with outsourcing you had to get the consent of the commission each time you outsourced new business; that’s been clarified. Sensible outsourcing relieves some of the stresses and strains that would otherwise build up in the island, and allows it to attract new business that is regulated through the licensed service providers here."

As some industry members cite a figure
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In a period of exceptional growth for the fund industry generally in Guernsey, the hedge fund sector is growing rapidly and maturing, a result of a number of factors including the widening of its definition.

The eternal dilemma of defining what a hedge fund is continues to become more difficult. No longer do managers of funds engaged in event-driven and arbitrage strategies, for example, claim to be the sole purveyors of hedge funds, which now encompass a wide variety of long-only strategies. The descriptions ‘alternative’ and ‘hedge’ seem to have merged where there isn’t an established distinction as for private equity or property, and even then we have seen the crossover of hedge fund concepts into both of these arenas.

What has driven this scope creep is open to debate. It could be that because alternative strategies are complex, they are akin to hedge funds; it could be their managers are attracted by the 2 and 20 remuneration; it could be a need to be involved with a high-profile and trendy sector; or cynically it could be a deliberate aim by the industry in order to subsume everything that’s alternative.

Guernsey, which has long prided itself on its alternative expertise, initially had few directly invested hedge funds, but a much larger number of funds of hedge funds. With this divergence of definition, it could be that the business undertaken for years in other alternative sectors including debt, catastrophe and art is actually indicative of much longer-established hedge funds experience than previously recorded.

Another point of view is that the divergence in definition is a tacit acceptance that the genre has now become mainstream.

In 2005, KPMG and Create released a report highlighting how hedge funds were set fundamentally to impact the wider investment management community. It is interesting now to look back and see just how deeply this has occurred. Early convergence themes were seen between the private equity and hedge fund worlds, but now more traditional managers, for example, are creating in-house boutiques that allow managers to operate as if they were independent hedge fund managers.

Convergence is making the mainstream become more complex, with a knock-on impact on the industry’s service providers. Guernsey is far from immune to this trend toward complexity, which is driving change in business models. The administration sector has seen growing merger and acquisition activity, notably the recent State Street deal with IBT.

While many managers in the hedge fund and private equity sectors have set up operations in Guernsey, they still use the services of local administrators. Over the past few years new administration operations have sprung up as offshoots of local banks, trust companies and legal firms, all trying to capture a piece of the cake.

As complexity becomes mainstream and administration more challenging, it remains to be seen how the sector will cope. IT spending and well-trained personnel are a prerequisite to servicing this sector. While Guernsey has an enviable reputation for quality of service and team working with client organisations, it cannot rest on its laurels in the face of competition from much larger organisations in jurisdictions elsewhere.

We will continue to see strong growth in the sector; we may see more consolidation of administration in the medium term; we will certainly see increased use of outsourcing, but we are unlikely to see anything other than a challenging environment for this industry for the foreseeable future.
of as many as 300 unfilled vacancies in the island’s administration sector, a number of firms are already taking advantage of their global network of administration offices or setting up dedicated facilities in countries including India and South Africa.

“Groups like HSBC, Northern Trust and Royal Bank of Canada have operations all over the world,” says Guernsey Finance chief executive Peter Niven. “We can manage the business by selectively outsourcing, but what we don’t want to do is go the whole nine yards to the Cayman model. We have a strength and depth of expertise here across all parts of the industry which we don’t want to lose.”

Stuart Mauger, head of sales and business development for corporate and institutional business in the British Isles with Royal Bank of Canada, says: “It is difficult to find quality staff, because there are competitors and independent administrators, and we’re all chasing the same labour. That’s where our global network comes in. On the custody side the operation is in Jersey, so we have access to another pool, and we are probably one of the largest employers on the securities side in the two islands.”

Says another Ozannes partner, Gavin Farrell: “There are three ways of approaching this. The first option, which we’re seeing more and more, is the manager wanting to do some of the investor relations and administration activities in its home jurisdiction, if it has the resources. The second is very large banks that offload some of the day-to-day work to offices in other jurisdictions that may not be as busy as Guernsey. The third is a purely commercial arrangement under which the administrator outsources to an unconnected company in Guernsey with which they have a good relationship.”

Says Moffatt: “Our policy on outsourcing has been virtually unchanged for 10 years. We will allow people to outsource all sorts of activities. We used to work on the basis that they would tell us what they wanted to outsource and we would look very closely at what they proposed to do, their systems and procedures and their agreements. We’ve moved much more to a notification basis, and we deal with outsourcing oversight as part of our monitoring.

“The one thing people can’t outsource is responsibility. You can’t just outsource something, turn your back and walk away. And if the outsourcing doesn’t work, you have to either bring it back in-house or have another third party to whom it can be transferred. We tell people: ‘Don’t ever come to us and say something went wrong because the people to whom you outsourced it fouled it up. You fouled it up because you didn’t spot it.’”

Says Capita director Richard Boléat: “There’s a lot more administration done in Guernsey now than there was a year ago, but most big players now chop up administration work into its constituent parts to be carried out in centres of excellence. Governance tends to be carried out where the fund is domiciled, but NAV calculation may be done in another jurisdiction and fund accounting in yet another where there are plenty of accountants.”

Capita is carrying out this work in Mumbai, while HSBC has launched an offshoring venture in Kolkata. Says Petsche: “We are looking at being able to provide 24/6 service from September out of our Indian office. It’s offshoring rather than outsourcing because HSBC has invested in bricks and mortar. It’s not something that we woke up one day and decided to try out, but an ongoing project for more than 18 months.”